Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: jamesgunn@ifac.org

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Exposure Draft, Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)

Dear Mr Gunn

The Basel Committee on Banking Supervision (the Committee) is pleased to respond to the IAASB's Exposure Draft (ED) *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*. As mentioned in the Committee's 12 October 2012 response letter to the IAASB's Invitation to Comment: *Improving the Auditor's Report*, external audits of banking organisations are an important element of the bank supervisory process. The Committee supports high-quality audits of banks because, coupled with the communication of useful information by auditors to users of the audited financial statements, they enhance market confidence.

General comments

The Committee supports the proposed changes to the auditor's report and the new and revised ISAs. The proposed changes would significantly improve auditor reporting, which should reduce the information and expectation gaps of auditors and users of audited financial statements. The Committee strongly believes that reporting on key audit matters (KAMs) informs users on how the auditor has applied professional judgment and reached an audit opinion, thus helping to strike the right balance between information provided by the auditor and that provided by management.

The ED mandates the use of the enhanced auditor's report for listed entities only. Given the critical role of banking organisations in maintaining financial stability and the nature of their business, we believe enhanced audit reporting could lead to consequential improvements in the quality of audits. Therefore, the Committee recommends that the IAASB require enhanced auditor's reports to be provided for all banking organisations (regardless of whether they are listed). Alternatively, as discussed in our 12 October 2012 response letter, the ED could be revised to define the term "public interest entity" and require the use of the enhanced auditor's report for public interest entities. We would recommend that the term "public interest entity" include, at a minimum, listed entities and banking organisations. Furthermore, because banks and other entities use their customers' audited financial statements, where available, to make credit and other business decisions, the Committee recommends that the ED encourage the use of the enhanced auditor's report for audits of all entities.

The Committee supports the IAASB's proposal to encourage audit firms to field test the application of proposed ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*. Through field testing, audit firms may identify areas for which further guidance and/or clarification may be needed, as well as any implementation challenges. These challenges may include achieving an appropriate balance between the transparency of information disclosed in the auditor's report and the relationship between the auditor and those charged with governance.

The Committee also supports the IAASB's intention to undertake a post-implementation review of the proposed new auditor's report requirement, and to revise the standards as needed.

Additionally, as explained in the paragraphs below, the Committee believes that some of the proposals could be further developed to ensure consistency in application and clarity of disclosures, so as to further promote high quality audits and auditor reporting.

Structure of the audit report

The proposed structure of the audit report is clear and easily distinguishable by section headings. These headings will help users of financial statements better understand the responsibilities of management and the auditor and the differences between them.

The Committee strongly supports a requirement for a prominent placement of the auditor's opinion in the auditor's report, ie at the beginning of the report.

Although the Committee understands that the auditors' reports as set out in the Appendix to the proposed ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements* are for illustrative purposes only, the Committee expects these examples to serve as the models for the reports that auditors will begin to issue on implementation of the final standard. The Committee suggests that the elements of the illustrative auditor's reports should be arranged to present those that directly relate to the financial statement audit before those that relate to the other additional work prescribed by local law, regulation and national auditing standards. This would aid the users' understanding of the financial statements. For example, the sections describing management's and the auditor's responsibilities could be placed immediately after the auditor's opinion, while the "*Other information"* section, which is not directly related to the opinion on the financial statements, would be better placed just before the "*Report on other legal and regulatory requirements*" section.

Key audit matters

The Committee believes that the auditor's communications with those charged with governance are a good starting point for determining the KAMs to be included in the auditor's report. In making this determination, the external auditor should consider areas where accounting policy choices of significance to the audited entity's business activities exist and accounting estimates are subject to significant management judgement.

The discussion of KAMs should provide users of the auditor's report with useful information on aspects and areas of the entity's financial statement assertions that drew significant auditor attention during the conduct of the audit. However, the Committee believes that some of the proposals need to be developed further to improve consistency in application and clarity of disclosures. For example:

(i) The description of the auditor's objective in paragraph 6 of proposed ISA 701 could be enhanced by making references explicitly to the usefulness of the information for users' understanding of those matters that were of most significance in the audit of the entity's financial statements of the current period (as noted in paragraph 2 of the proposed ISA 701). A clearer and stronger objective should help to assist the auditors in determining the KAMs to be disclosed in the auditor's report.

(ii) Paragraph A20 of proposed ISA 701 provides examples of potential significant difficulties that an auditor may encounter during an audit. According to paragraph A21 of the proposed ISA, in some instances, the difficulties encountered during the audit may constitute a scope limitation that requires a modification of the auditor's opinion. Paragraph A21 further states that a matter giving rise to a modification of the auditor's opinion is, by its nature, a KAM. In these circumstances, the description of the KAM leading to the modified opinion is to be presented in the "Basis for Qualified (or Adverse) Opinion" section of the auditor's report instead of the KAM section. Given the significance of a modified opinion to users of the auditor's report, we believe it may be beneficial for the application materials for paragraph 8(b) of proposed ISA 701 to be expanded to reiterate the examples of significant difficulties encountered during an audit identified in paragraph A18 of proposed ISA 260 (Revised).

(iii) The required elements of the description of each KAM as set out in paragraph 10 of proposed ISA 701 are minimal and may not provide sufficient useful information to users. These requirements could be enhanced to call for more robust and entity-specific descriptions of KAMs. For example, portions of the text contained in paragraphs A31 and A38 of the proposed ISA could be incorporated into paragraph 10 to encourage a more consistent, comprehensive and entity-specific description of KAMs in the auditor's report.

(iv) The interaction between proposed ISA 701 and proposed ISA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, requires further clarification. Paragraph A2 of proposed ISA 706 (Revised) suggests that when a financial statement matter is communicated as a KAM in an auditor's report, it may not need to be included in an Emphasis of Matter (EoM) paragraph. The Committee is concerned with this approach as, in our view, this could undermine the different objectives of proposed ISA 701 and proposed ISA 706.[1] It is likely that a financial statement matter that is fundamental to users' understanding of the financial statements (eg provisions for litigation), could be the subject of an EoM paragraph because of the outcome uncertainty, but it could also be covered in a KAM given that it involves significant auditor judgment. We would not presume that the inclusion of KAMs in auditors' reports would necessarily lead to the use of fewer EoM paragraphs.

ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management,* requires the auditor to communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance. Paragraphs 8(c) and A23 of proposed ISA 701 indicate that a significant deficiency may be an indicator of a KAM relating to the affected areas of the financial statements. Thus, in some cases when a significant deficiency in internal control has been identified, the auditor may determine that the affected area of the financial statements is not a KAM. In these situations, the Committee recommends that proposed ISA 701 should require the auditor to evaluate whether any of the significant deficiencies in internal control not associated with a KAM, or a combination of these significant deficiencies, is such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected on a timely basis. If the auditor concludes that such a material misstatement is reasonably possible, the Committee believes that this information, by its nature, would be meaningful to users of the auditor's report. Thus, the IAASB should consider treating significant deficiencies that meet this condition as a KAM to be communicated in the auditor's report. The auditor's description of such significant deficiencies should explain the effect of their existence on the audit and the auditor's planned approach to the audit.

In addition, instead of the statement that "*our opinion ... is not modified with respect to any of the key audit matters…, and we do not express an opinion on these individual matters*",[2] the Committee would recommend a more positive assertion that the auditor's consideration of KAMs as a whole has contributed to the auditor's opinion as stated in the report.

Going concern

The Committee understands the proposal to require the auditor to include in the auditor's report a conclusion regarding the appropriateness of management's use of the going concern assumption. We agree that a specific statement regarding whether, based on audit work, the auditor has identified material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern should be included. However, given banks' sensitivity to and dependency on liquidity and solvency, we encourage the IAASB to consider the specific circumstances associated with banks' ability to continue as

[1] The objective of the proposed ISA 701 is to require auditors to communicate matters that were of significance in the audit of the financial statements. The objective of proposed ISA 706 (Revised) is to draw users' attention to a matter(s) presented or disclosed in the financial statements that is fundamental to users' understanding of the financial statements.

[2] Such a statement would be required in the auditor's report by paragraph 9(d) of proposed ISA 701.

a going concern when the auditor makes the assertion that a bank has no material uncertainties, even in the normal course of business. To supplement ISA 570 *Going Concern (Revised)*, the Committee believes that there is merit in the IAASB developing specific authoritative guidance for audits of banks that would cover an auditor's consideration of a bank's particular risks, including regulatory liquidity and capital information, and the overall regulatory and reporting environment.[3]

Additionally, the Committee is concerned with the requirement for an explicit statement by the auditors that neither management nor the auditor can guarantee the entity's ability to continue as a going concern. While the Committee understands that this requirement is included to help to narrow the expectation gap on the level of assurance an auditor can provide related to going concern, the common understanding of the word "guarantee" in and of itself may dilute the usefulness of the going concern paragraph. It may reduce the user's confidence in the audited financial statements, which is counterintuitive to the objective of the requirement. The Committee suggests adding further context to this statement and amending it as follows: "*Because neither management nor the auditor can predict the effects of all events or conditions on the entity, neither management nor the auditor can provide assurance of the entity's ability to continue as a going concern*".

With the forthcoming changes to International Financial Reporting Standards and US Generally Accepted Accounting Principles with respect to going concern, the Committee encourages the IAASB to work closely with the International Accounting Standards Board, the US Financial Accounting Standards Board and the US Public Company Accounting Oversight Board to take a coordinated approach to establishing consistency for key concepts such as the identification of material uncertainties, foreseeable future and significant doubt as well as the related disclosures. The application of going concern accounting and auditing standards becomes increasingly important under conditions of significant economic uncertainty, such as a financial crisis. Therefore international consistency would be crucial.

Description of the responsibilities of the auditor in conducting the audit

The Committee believes it is important that the description of the auditor's responsibilities, which is directly relevant to the provision of an auditor's report, is adequately disclosed in the auditor's report. It is beneficial for users of financial statements to have such information in hand without having to refer to other external sources for information on the auditor's responsibilities.

With respect to the description of the auditor's responsibilities, paragraph 36(b) of proposed ISA 700 (Revised) defines *reasonable assurance* as "*a high level of assurance, but is not a guarantee*". The Committee believes it could be better defined as "*a high, but not absolute, level of assurance*", which is in line with the definition of the term "reasonable assurance"in the IAASB's Handbook of International Quality Control, Auditing Review, Other Assurance, and Related Services Pronouncements.

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[3] Previously communicated in the Committee's letter to the IAASB dated 21 March 2013, which is accessible by visiting www.bis.org/bcbs/commentletters/ifac45.pdf.

Reporting to those charged with governance

Paragraph 19 of proposed ISA 260 (Revised) allows oral communication to those charged with governance (TCWG) regarding significant findings from the audit. Although the Committee does not wish to limit such oral communications, we would like to reiterate the request in our letter to the IAASB dated 21 March 2013 that all significant audit findings should be communicated to TCWG in writing.

These comments have been prepared by the Committee's Accounting Experts Group, which is chaired by Mr René van Wyk, Registrar of Banks, South African Reserve Bank. If you have any questions regarding our comments, please feel free to contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely

Stefan Ingves